2024 INVESTMENT OUTLOOK

A fine balance

Inflation, interest rates and economic growth remain the dominant themes for the year ahead

Omnis INVESTMENTS

Andrew Summers
Chief Investment Officer

The year ahead

We are pleased to publish this year's outlook following a strong 2023 for most equity and bond markets, which delivered solid returns for our clients' portfolios. We noted 12 months ago that the year ahead would be dominated by the market's reaction to economic growth and inflation, as proved to be the case. By the summer central banks had paused their interest rate rises, while they waited to see how the economy reacted to the largest increase in the cost of borrowing money in recent history.

The reaction was the persistence of the economic slowdown that had caused so much angst in 2022 into 2023 but also, crucially, the continuing decline in inflation. Although welcome, markets have begun to show signs of complacency, especially towards the end of last year.

Companies are expected to grow revenue and maintain profit margins against a backdrop of economies feeling the impact of higher interest rates. At the same time, the bond market is already expecting several interest rate cuts on the prospect that central banks have inflation under control.

There are two main risks to returns from equity and bond markets in 2024. First, the pace of economic growth could be slower than expected. Second, central banks may not reduce interest rates as rapidly as the market expects.

The outlook for equity and bond markets

Our main scenario for 2024 is a year of muted but positive returns from equities and bonds, but as always there is scope for better or worse outcomes. Regardless of what the year ahead may hold, we invest for the long term and construct portfolios around our strategic asset allocation forecasts. Using this framework, we make investments in specific markets for shorter time periods according to our tactical asset allocation views.

According to our long-term asset class return expectations (which are based on a 10- to 15-year horizon), all our risk profiles are likely to deliver returns in excess of cash savings and inflation. However, these returns are less likely over shorter periods, which is why it's important to remain invested and remain focused on your long-term goals.

This is my first outlook as the Chief Investment Officer of Omnis Investments. I have been impressed with the quality of investment decision making at every level and look forward to building on that in different areas this year. We believe our thoughtful and considered approach to strategic and tactical asset allocation combined with investing with the best fund managers in their space will enable us to fulfil our role in helping our clients meet their financial objectives.

A year in review 2023

Global economic and financial market highlights

Jan

- Optimistic start to year buoyed by lower inflation
- World Economic Forum in Davos announces a more positive outlook than investors feared

Feb

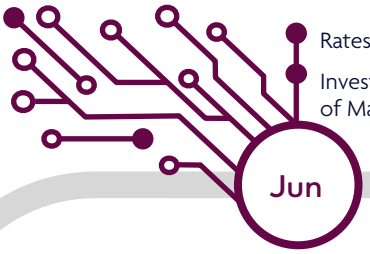
- US inflation uptick and strong growth sparks fears of more interest rate hikes

Mar

- Banking turmoil with Silicon Valley Bank and Signature Bank collapsing
- UBS takes over Credit Suisse

Apr

- US jobs boom starts to slow



May

- Sticky UK inflation spooks market in contrast to fading US inflation
- Coronation of King Charles III

Jun

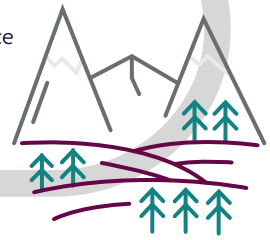
- Rates pause in US after 10 hikes
- Investors start to notice the outsized gains of Magnificent Seven US tech stocks

Jul

- US raises rates to highest level in 22 years
- Barbie and Oppenheimer craze at cinemas

Aug

- China's economy loses steam, with a property slump and weaker consumer spending
- Donald Trump is the first US president to face criminal charges in a federal court



Sep

- Higher for longer narrative takes over markets after Fed announcements on interest rates
- Bank of England leaves rates unchanged and ECB says rate rises may now be over

Oct

- Substantial bond sell-off from higher for longer expectations

Nov

- Fading inflation is an established trend
- Stocks and bonds rally as investors believe central banks have now reached peak interest rates

Dec

- Stock and bond markets continue to climb into the end of the year
- Expectations that central banks will start to cut interest rates in 2024

Heading for a soft landing

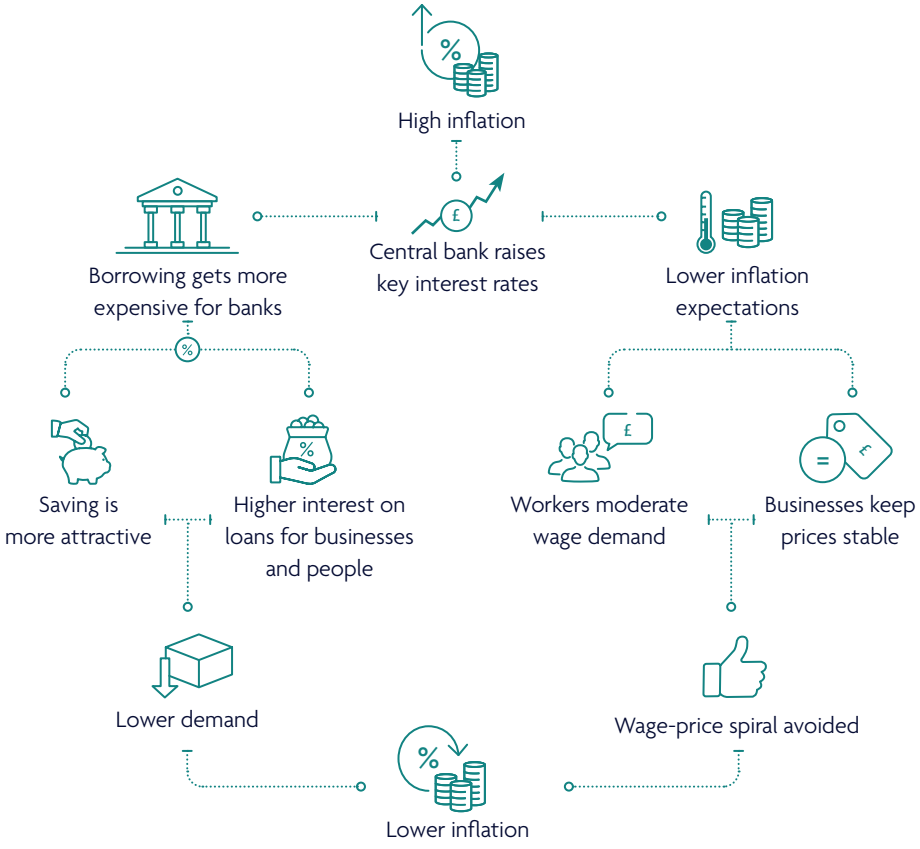
There are reasons to be optimistic that global economy can avoid the most damaging sort of economic downturn, although risks remain

As we enter 2024, we see complacency in areas of the global financial markets considering where we are in the economic cycle and the potential outcomes. Volatility is low, we see little excess returns available from corporate bonds over government bonds, corporate earnings expectations look rosy, and most equity markets are little better than fair value and expensive in the US.

Equity markets are usually forward looking – they look forward to what the economy may do, and the price of equity markets typically reflect the market's view on the global economy. Since late 2023 the market's view is that we will have what is known as a soft economic landing. This occurs when central banks raise interest rates enough to bring down inflation to an acceptable level without those interest rate rises causing a severe recession, where we see the economy shrinking. Once inflation is tamed, interest rates should be able to be gradually brought down to bolster the economy without reigniting that recently beaten inflation.

Figure 1: Inflation, interest rates and economic growth

The key for central banks will be to lower demand in the economy by enough to bring inflation under control, but not so much that the economy chokes and falls into a severe recession.



Source: Omnis Investments

Barring some unforeseen event, central banks have now raised interest rates as high as they think they need to go, and are waiting to see whether they have done just enough to engineer this soft landing. This expected plateau (to last several more months) of interest rates, followed by steady but meaningful cuts in interest rates is the perfect outcome of a soft landing that markets are expecting and are pricing in.

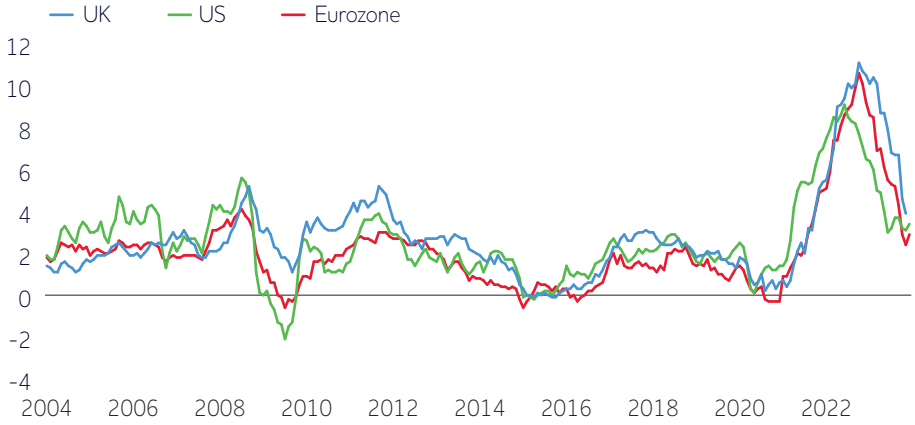
Rising interest rates have tamed inflation

While we think this outcome is certainly possible, we are alert to the likelihood that it may not. The full effects of these interest rate rises on the economy, and thus both equity and bond markets, have not yet fully materialised. Understanding what we think they will be and how central banks will react as the evidence comes in will be central to our investment decision making in 2024.

First, a recap. Inflation has risen to a generational high and fallen again after the fastest and sharpest interest rate hiking cycle in a generation. History suggests this would result in a recession, and falling equity markets. This has still not happened, which is the reason most developed world equity markets did not fall in 2023. On that basis, we are on track for the perfect outcome of a soft landing.

Figure 2: Inflation has faded around the world (%)

Higher interest rates have had the desired impact on the pace of price rises.



Source: Bloomberg as of 31 December 2023. UK inflation data is as of 30 November 2023.

The reason for this positive outcome so far has been the surprisingly muted impact of these interest rate rises. First, from 2020 to 2022 many consumers and companies took the opportunity to lock in borrowing at record low interest rates for as long as possible, meaning that subsequent rises haven't impacted them yet.

Imagine you locked in your mortgage rate for five years before interest rates started going up. You won't be affected until the deal ends, and interest rates are likely to have fallen by then.

As a result, higher interest rates have not dampened consumer spending or business investment and hiring by as much as would be expected given the speed at which they have risen. In addition, consumers have been able to rely on considerable savings accumulated during the pandemic and most governments have run large budget deficits to support spending as the economy emerged from the pandemic.

This situation has created a benign environment for most companies, which is good for their share prices. Many businesses have also benefited from elevated inflation because it enables them to raise prices and maintain their profit margins.

A soft landing for the global economy is likely

The global economy may be about to experience significant productivity gains as more businesses adopt artificial intelligence (AI) technologies. The services sector is likely to benefit the most but AI could also boost the manufacturing sector. As a result, the slowdown in the pace of growth that higher interest rates have brought about may not be as pronounced as forecast.

Yet the prospects of a soft landing face considerable hurdles. As mentioned above, it requires central banks to be confident that inflation is falling sufficiently to enable them to cut interest rates to the extent the market is expecting. Inflation is coming down and we expect it to come down further, but it may not fall by as much or as quickly as the market expects.

This could be because past high inflation has led workers to demand equally high wage increases, which results in inflation expectations becoming embedded in wage negotiations. If employees expect inflation to continue to remain high, they will continue to demand higher wages to compensate for that. In turn, this drives companies to raise prices to be able to pay these higher wages, which accelerates inflation even further.

Wage inflation needs to decelerate to enable headline inflation and inflation expectations to abate. That will give central banks the cover to begin reducing interest rates this year as the market expects.

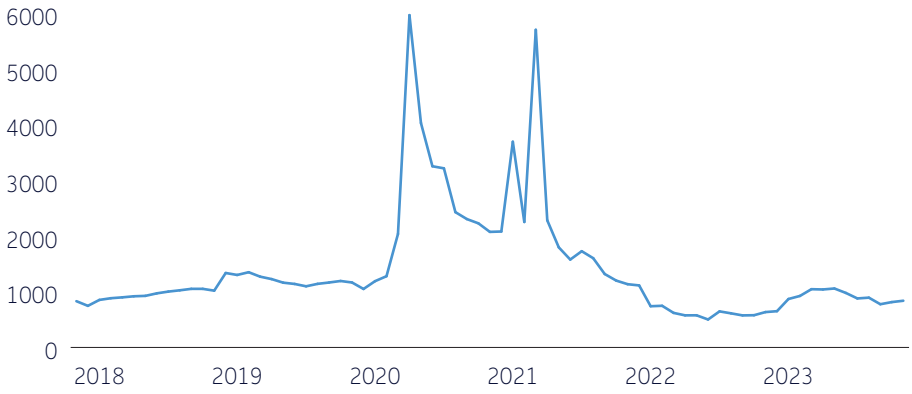
For wage growth to decline, the brutal fact is that workers need to be fearful of unemployment to tame their demands. That will only happen if the economy is performing poorly and unemployment is rising. This is the outcome that the market is expecting but a deep recession remains a risk.

Pandemic savings are largely exhausted

In addition to the labour market challenges, the economic support delivered to date by consumers spending their pandemic savings has all but dwindled. Indeed, despite many consumers and companies effectively shielded from recent interest rate rises as described above, plenty are not. We have seen a large increase in people falling behind on monthly credit card payments and there are clear signs of the housing market cooling down. Historically this is a presage for much weaker economic conditions.

Figure 3: US personal savings

Household pandemic savings have been largely spent.



Source: Bloomberg as of 30 November 2023.

As inflation falls, companies that had been able to use higher inflation to raise prices will be increasingly less able to do so. When combined with the inevitable effects of higher interest rates (e.g. higher interest costs are starting to hit profits of companies with debt) and a sluggish economy as it digests record interest rate rises, this is likely to have a negative effect on the performance of companies and thus a negative effect on share prices.

Government debt levels are looking stretched

In addition to consumers and companies facing the consequences of recent interest rate rises, so too will governments. Having supported the global economy through the global financial crisis and the pandemic, government debt levels of over 100% of annual GDP, or nearing it, are commonplace. They are still growing at quite a clip as governments continue to run budget deficits. But governments too must now fund themselves at higher levels of interest rates. Therefore, we can reasonably expect that at some point most governments will further reign in spending or raise taxes, reinforcing the impact of central bank interest rate hikes on the economy.

This discussion demonstrates the finely balanced nature of the economy and financial markets at the start of 2024. Should economic activity continue to be too elevated to bring inflation down enough to satisfy central banks, they won't reduce interest rates as much as the market hopes. Indeed, it is not inconceivable that they could raise interest rates again, though we think this unlikely.

Various events could encourage central banks to rethink their interest rate policies. For example, if the conflict in the Middle East leads to substantial oil price rises or disrupts shipping routes, the rate of inflation would probably rise. This would be received very negatively by both the bond and equity markets, which are banking on the perfect outcome of a soft landing and have yet to fully digest the record speed of recent interest rate increases.

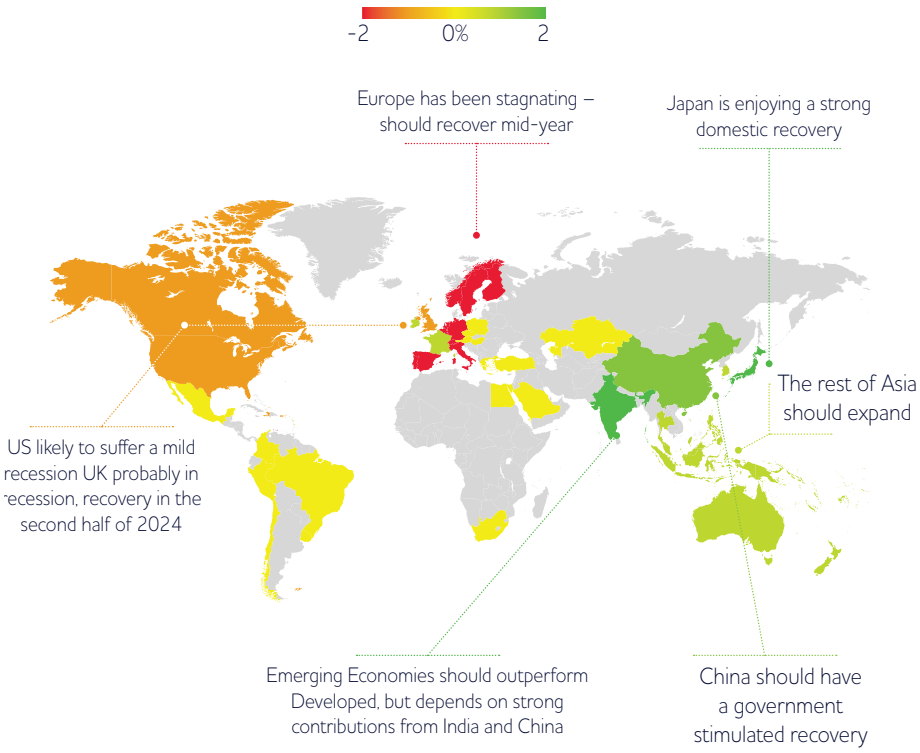
In contrast, should economic activity fall more than central banks need it to (i.e. it turns out that central banks have risen interest rates by too much), this will likely lead to central banks cutting interest rates more than the market expects. This will be good news for bond markets. However, the impact on equity markets is less clear. They might respond positively to the fact that interest rates are falling more quickly than expected, but they would also be negatively impacted by the weaker economic outlook.

So where does this leave us? We think the global economy will flirt with recession in 2024, but ultimately avoid the worst outcomes (figure 4). We think the US could experience a mild recession, whilst the UK is probably already enduring one. The European economy will probably remain flat until the second half of the year before recovering, along with the UK.

The rest of the world has a rosier picture – increasingly important emerging markets will provide support, India through continued reforms and China through further government stimulus. This should support growth in the wider Asia Pacific, as will Japan, which is enjoying a domestic recovery from a long period of stagnation.

Figure 4: Global growth is likely to flirt with recession in 2024

Europe looks likely to fall into recession, while the US continues to defy expectations.



Source: Omnis Investments

Inflation continues to fade

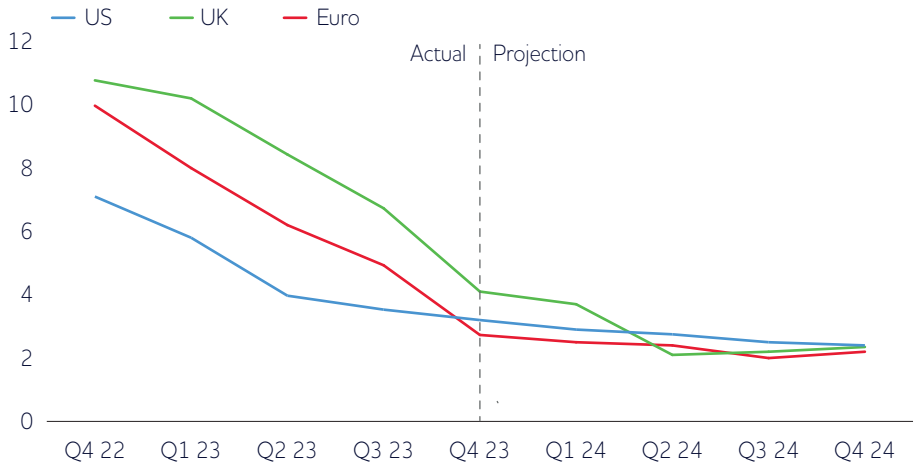
It is too early to sound the all-clear on inflation, but that time is coming

The pace of inflation around the world is likely to slow further in 2024 but the large falls in the last three months of 2023 are likely to fade. The general trend should still be lower, but the journey is likely to get a little bumpier.

Regionally, the US is having more success and inflation is likely to fall to just over 2% by the end of the year. This gives the US Federal Reserve (Fed) plenty of space to cut interest rates down to a more neutral level. Likewise, inflation in the euro area should end the year just above 2%. Inflation in the UK is a little more problematic, but by the end of 2024, inflation should be below 3%.

Figure 5: Inflation expectations (%)

Economist expect inflation to remain subdued over the year ahead.



Source: Bloomberg as of 16 December 2023. Projections are taken from 68 surveyed major investment banks.

Interest rates are likely to fall this year

We expect that a combination of falling inflation, modestly rising unemployment and a generally tepid economic growth backdrop will ultimately enable central banks to reduce interest rates in 2024, beginning in the summer, perhaps even the late spring.

In previous cycles, the US central bank has acted promptly to cut interest rates in the face of economic weakness. We believe policymakers will be more guarded this time and expect interest rates to be cut modestly across the world. This is because central banks will want to ensure that interest rates remain in positive territory after being adjusted for inflation. They will also be keen to ensure that there is no chance of a reinvigoration of inflation.

However, the extent of interest rate decreases in 2024 will depend on how particular central banks want to be about seeing inflation at their 2% targets, given that it's likely to be higher throughout the year. Nevertheless, the weak economic environment ought to be enough to push policymakers into action close to what the market is expecting.

The outlook for investors

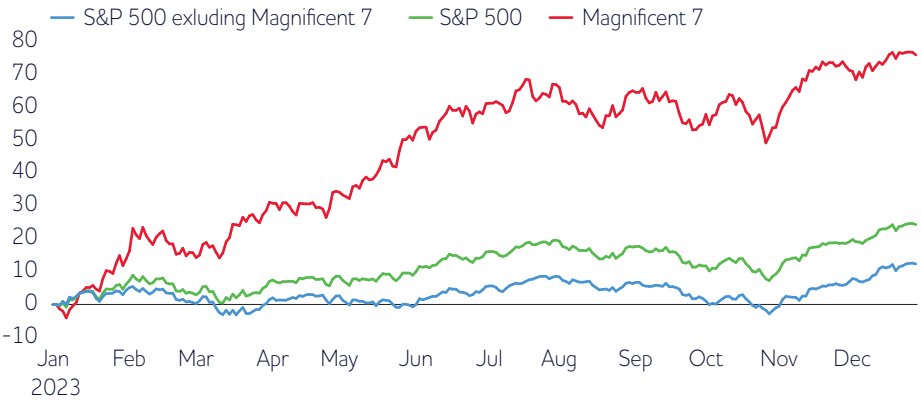
While returns from equities are likely to be subdued, government bonds should perform well

Returns from equities are likely to broaden after a narrow 2023

Equity markets performed better in 2023 than might have been expected given the record level of interest rate rises and slowing economy. This was especially the case in the US, although the impressive rise in the stock market masks a more complex picture. A handful of companies dubbed the Magnificent Seven (Apple, Microsoft, Google parent Alphabet, Amazon.com, Nvidia, Meta Platforms and Tesla) plus a larger number of technology and communications sectors trumped all as artificial intelligence fever gripped markets. The consumer discretionary sector followed as pent-up pandemic spendings were spent. For most US stocks, however, their performance was much more mediocre and reflective of a cooling economy and rising interest rates.

Figure 6: The Magnificent Seven

America's tech giants outperformed the rest of the market last year (December 2022 =100)



Source: Bloomberg as of 31 December 2023.

After being dominated by a relatively small number of companies last year, equity market returns are likely to broaden in 2024. Yet this does not necessarily mean we will see positive returns from all regions. In developed markets, revenue growth will probably be hard to come by as the effects of recent interest rate rises impacts profitability and their operating environment.

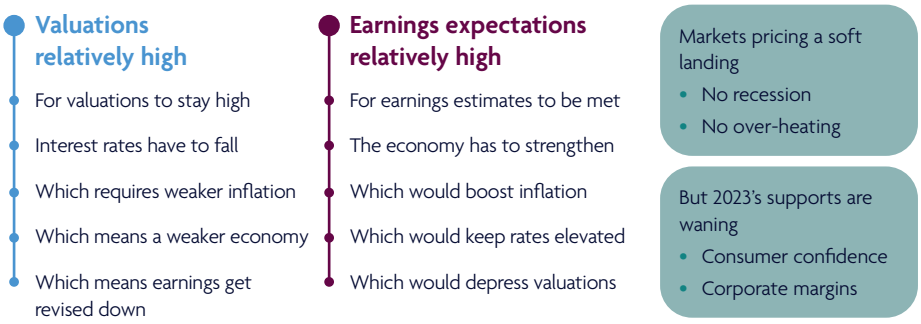
In the US in particular, this is compounded by the fact that the market is expensive on most valuation measures, which reflects the perfect scenario the market is pricing in. Even though we don't expect corporate America to have a terrible year, we think the market is expecting too much, and when they are disappointed this will result in poor share price performance.

If valuations are to stay this high, interest rates have to fall as markets expect and the fight against inflation is executed with perfection. That requires weaker inflation, which can only be delivered through a weaker economy, which we are already seeing. In reality, whether we achieve the perfect soft landing, or a shallow recession, we will see a weaker economy this year. A weaker economy means that earnings expectations will have to be reduced, which is bad news for equity prices.

For current (in our opinion) rather optimistic earnings expectations to be met, the economy probably has to strengthen from here, which would mean inflation not falling as quickly as the market expects, and interest rates not falling as quickly either. As explained above, this would deprive equity markets of the boost that would otherwise come from interest rate cuts in pursuit of the perfect scenario.

Figure 7: Implications for equities

The impact of inflation, interest rates and economic growth on investment returns.



Source: Omnis Investments

Even though we don't expect corporate America to have a terrible year, we think the market is expecting too much. Any disappointments are likely to result in poor share price performance.

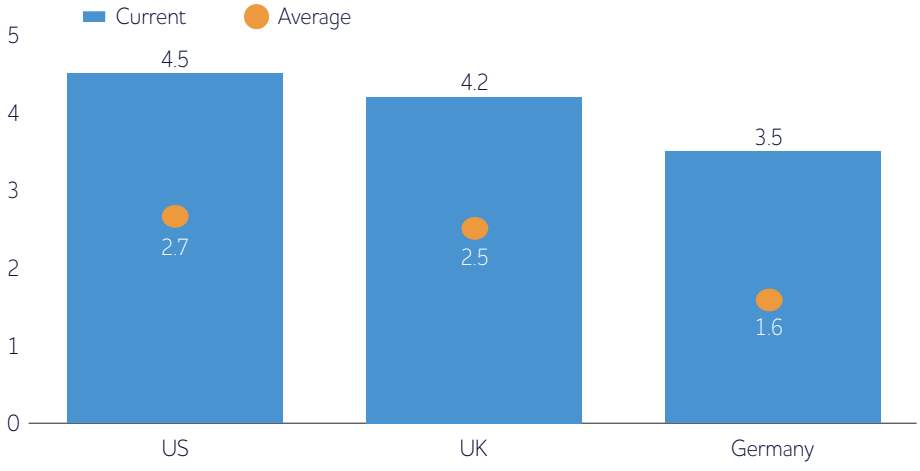
It is hard to see a strong equity market rally in 2024, but neither is our central scenario a negative year. Rather, in the face of slower revenue growth, the key will be using our active managers to pick those companies that can maintain their margins and generate or exceed the earnings the market is expecting. 2024 will be about investing in good business and not just about 'investing in markets'. Overall, the most likely scenario is that equities are in for a tepid year, rather than a strong year or a drawdown to remember.

Bonds are likely to have a decent year of performance

Whereas we see equity markets in general delivering their long-term expected returns at best, we think government bonds will deliver good returns relative to their long-term potential. Government bonds in particular now benefit from yields as high as they've been in more than a decade.

Figure 8: Government bond yields (%)

Relative to history, yields on government bonds look like they are fair value. However, if we exepect a continued slowdown in economic activity, these yields look even more attractive.



Source: Bloomberg as of 16 January 2024. Yields are representative of 10-year government bonds.

This higher yield should provide decent return for bond investors. Furthermore, the likelihood of falling interest rates means investors can lock in these decent yields and experience some capital gains in the interim. It's unlikely that returns will compensate for the losses of 2022 for a few years, but we don't invest in the past. We think the outlook for bond markets looks reasonably positive for the coming years.

Asset class returns are becoming more diversified once again

All of this makes us feel that caution is the best approach for 2024. Where we are able to, we have decreased our allocations to equities and increased our allocation to government bonds.

Much of the period since the global financial crisis meant that traditional portfolio construction techniques faltered. Bond yields were too low for them to be an attractive source of returns and, just as importantly, they stopped being negatively correlated with equities. In other words, the traditional bedrock of a diversified portfolio was absent – owning equities and bonds, in the belief that when equities go down, typically bonds go up, thereby combining them creates a less volatile return profile.

This reflected the elevated level of inflation at the time and central banks raising interest rates to calm it. For bonds, the maths is simpler – higher interest rates mean falling prices (which we saw in 2022). For equities, the rapidly rising interest rates led investors to fear a significant economic slowdown which would hurt profits and thus equities fell as well. Now that inflation is returning to more normal levels, we don't expect this positive correlation to persist over the medium term, though there will be periods when it is present, and may be so for a while as markets await final confirmation that this inflation battle has been won.

This will help bring back the diversification benefits of owning bonds and equities. If the economy is strong and equities are rising, this will probably be accompanied by rising yields, which is a good sign, but will be bad news for bonds. Conversely, if the economy is weak and equities fall as a result, this will probably be accompanied by falling yields, which will be positive for bonds. Diversification is set to make a comeback. In the meantime, bonds once again provide income, some margin of safety and when the dust settles on the growth-inflation trade-off, should again provide portfolio diversification

Patience and commitment

Why it's important to stay focused on your long-term financial goals

Over the past few years, a global pandemic, elevated geopolitical risk, record high interest rates and a weakening global economy have led to rising interest rates and financial market volatility. Yet with the outlook becoming more optimistic in the last few months of 2023, the annual returns from both equities and bonds were much better than many expected.

The year ahead is likely to be sharply focused on whether central banks have managed to increase interest rates by enough to bring down inflation to their targets, but without tipping the economy into recession. A soft landing is widely expected but it's likely to be close.

Nevertheless, with economic activity set to slow, the returns from equities are likely to be muted. In contrast, government bonds should do well as interest rates begin to fall.

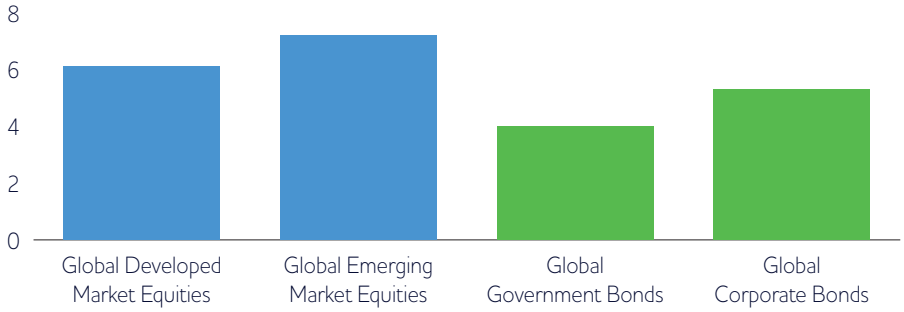
Investing for the long-term

It is always tempting to over-react to market developments, and change the way in which we invest, which would be a mistake. When we invest our clients in certain risk profiles, it is with the expectation that in the long run their investment requirements will be met.

In constructing these risk profiles, we assume long holding periods and use significant periods of past data to support them. In other words, when deciding on the optimum mix of asset classes needed for a given risk profile, we account for the fact that markets are cyclical and we will experience economic slowdowns and market downturns at some point, and in many cases more than once, during your investment period. The long-term outlook for major equity and bond markets looks reasonably compelling from this point.

Figure 9: Expected annualised returns over the longterm (10–15 years)

The long-term forecast remain positive for all main asset classes (%).



Source: JP Morgan Capital Market Assumptions. Global Corporate Bonds are representative of Global Credit. All return assumptions are in GBP.

Your financial adviser will be able to provide more details about the mix of investments in your portfolio, which will be in line with your risk profile. There is usually no need to change your risk profile in response to market developments. Long-term market return and risk expectations can change, but we account for these when reviewing our strategic asset allocation framework. We can also make medium-term changes through our tactical asset allocation process.

History shows that patience and commitment tend to reward investors. That's why it's important to remain invested and stay focused on your long-term financial goals. If you have any questions about your investments then please speak to your financial adviser.

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Approved by Omnis Investments on 18 January 2024.